Offices of Finance and Budget and Single Family Housing, Washington DC

Federal Housing Administration, Home Affordable Modification Program, Partial Claim Option

Office of Audit, Region 9
Los Angeles, CA

Audit Report Number: 2015-LA-0003
September 18, 2015

To: George Rabil
Deputy Assistant Secretary for Finance and Budget, HW

Kathleen A. Zadareky
Deputy Assistant Secretary for Single Family Housing, HU

Tanya E Schulze

From: Tanya E. Schulze, Regional Inspector General for Audit, 9DGA

Subject: HUD Did Not Have Effective Controls or Clear Guidance in Place for the FHA-HAMP Partial Claim Loss Mitigation Option

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the Federal Housing Administration's Home Affordable Modification Program (FHA-HAMP) partial claim loss mitigation option.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 213-534-2471.

Audit Report Number: 2015-LA-0003
Date: September 18, 2015

HUD Did Not Have Effective Controls or Clear Guidance in Place for the FHA-HAMP Partial Claim Loss Mitigation Option

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development (HUD), Federal Housing Administration's (FHA) Home Affordable Modification Program (HAMP) partial claim option because we noted issues in the postclaim review process during a previous partial claim audit.[1] Our audit objective was to determine whether HUD had adequate controls over its postclaim reviews and adequate policies in place to ensure that servicers properly understood the FHA-HAMP partial claim option.

What We Found

HUD did not have an effective postclaim review function and did not have clear program guidance in place for the FHA-HAMP partial claim option. As a result, HUD overpaid at least $177 million in partial claim notes due to servicer miscalculations, which affected at least 21,200 loans. Without additional controls, HUD will continue to overpay approximately $88.5 million per year. In addition, HUD's policies allowed servicers to determine partial claim amounts in different ways, which resulted in some claims that were higher than necessary. This condition occurred because HUD and its contractor did not produce quality postclaim review reports in a timely manner and HUD lacked attention to detail concerning FHA-HAMP.

What We Recommend

We recommended that HUD (1) assign the necessary administrative resources and oversight to reduce potential losses of $88.5 million per year for ineligible FHA-HAMP claim amounts that may go undetected, (2) require servicers to repay HUD $414,673 in ineligible partial claim amounts, (3) require servicers to provide support or repay $94,120 in partial claim amounts, (4) provide training to HUD staff and its contractor on all loss mitigation programs, (5) review a sample of postclaim reviews submitted by the contractor to ensure that the contractor adequately identifies ineligible claims, and (6) update FHA-HAMP policies to ensure that all servicers apply policies consistently.

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[1] OIG audit report 2015-LA-0001, issued April 20, 2015

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Background and Objective

In 1934, Congress created the Federal Housing Administration (FHA), which provides mortgage insurance on loans made by FHA-approved servicers throughout the United States and its territories. Under the program, servicers bear less risk because FHA will pay a claim to the servicer in the event of a homeowner's default; however, loans must meet certain requirements established by FHA to qualify for insurance.

FHA loss mitigation delegates to servicers both the authority and the responsibility to use certain actions and strategies to assist borrowers in default or imminent default in retaining their homes and reduce losses to the insurance fund that result from mortgage foreclosures. Servicers may use any of several loss mitigation options that lead to home retention. After evaluating a delinquent borrower for informal and formal forbearance plans, servicers must consider FHA's loss mitigation options in the following order: (1) special forbearances, (2) loan modifications, and (3) FHA's Home Affordable Modification Program (HAMP).

The U.S. Department of Housing and Urban Development (HUD) created the FHA-HAMP loss mitigation home retention option in response to the Helping Families Save Their Home Act of 2009. FHA-HAMP typically involves the combination of a loan modification and a partial claim. However, with the issuance of Mortgagee Letter 2012-22 on November 16, 2012, FHA-HAMP may now involve the use of one or both of those loss mitigation options.

HUD pays claims based on a form submitted by lenders and the certification that the claims are true and correct. Lenders are required to maintain a review file with complete records to support all claim submissions as noted in title 24 of the Code of Federal Regulations.[2] An automated claims system is used by HUD to ensure that a claim submission passes the established control parameters and edits before generating a payment to the lender. If the claim submission does not pass these edits, payment is withheld until the lender corrects the claim data. This process depends largely upon the accuracy and reliability of data submitted by FHA-approved lenders. As an internal control, HUD performs postclaim reviews to determine whether submitted claims are eligible.

For claims prepared from October 1, 2012, through September 30, 2014, HUD paid the top 9 servicers more than $4.6 billion for 194,202 FHA-HAMP partial notes and more than $78.9 million in incentive fees associated with the claims.

[2] Refer to appendix C, 24 CFR (Code of Federal Regulations) Part 203.

Our audit objective was to determine whether HUD had adequate controls over its postclaim reviews and adequate policies in place to ensure that servicers clearly understood the requirements of the FHA-HAMP partial claim option.

Results of Audit

Finding 1: HUD Did Not Have an Effective Postclaim Review Function

HUD did not have an effective postclaim review function in place for the FHA-HAMP partial claim option. This condition occurred because HUD's contractor did not produce quality postclaim review reports and HUD did not dedicate adequate resources for contractor oversight. As a result, HUD overpaid at least $177 million in partial claim notes due to servicer miscalculations, which affected at least 21,200 loans. Without additional controls, HUD will continue to overpay approximately $88.5 million per year.

HUD's Contractor Did Not Submit Adequate Postclaim Reviews

HUD's contractor submitted reports with mathematical and grammatical errors and did not note significant findings on its FHA-HAMP reviews. The HUD employee responsible for contractor oversight stated that his workload was too large to allow him to perform an indepth quality control review to determine whether the contractor's review process would identify ineligible claims. However, the HUD employee stated that the contractor's reports required many revisions due to grammatical and mathematical errors. According to the contract, the contractor should submit a hardcopy report in final form, with no typographical errors and in a professional format, suitable for signature and mailing, as appropriate, with no additional corrections or revisions needed.

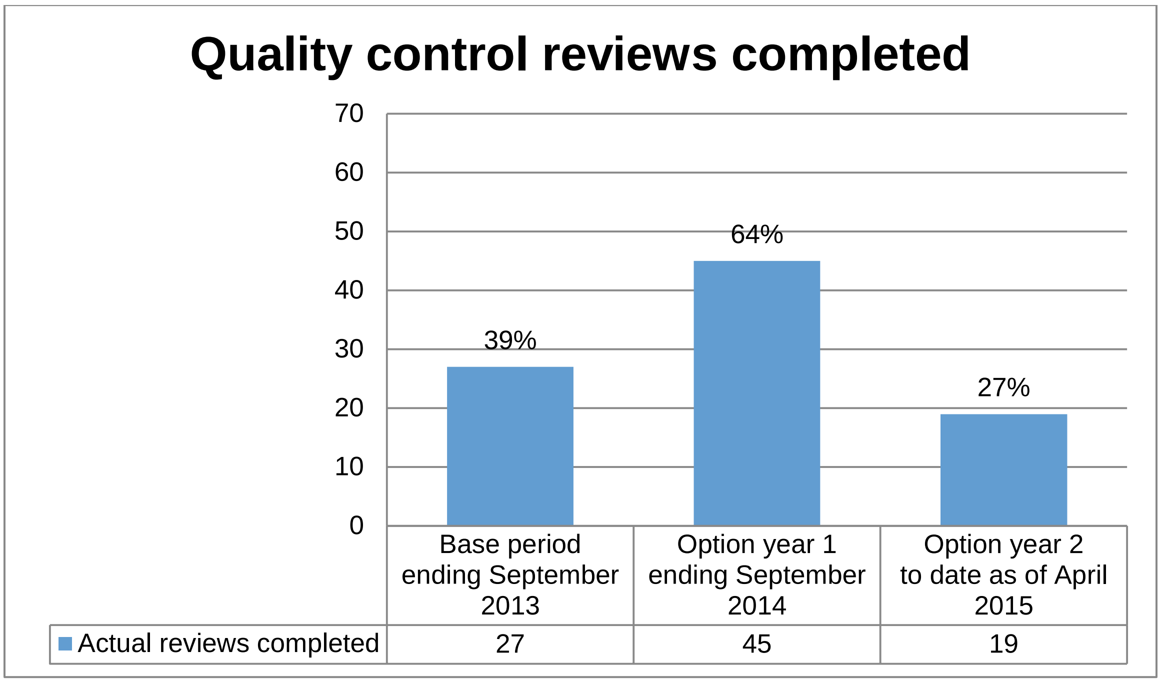
HUD had a statistical sampling plan in place that allowed it to project ineligible claims. The sampling plan grouped all loss mitigation claim types together to select a random sample and could result in few FHA-HAMP claims being reviewed. Because of the sample methodology and because HUD was behind on approving reviews, we were able to review the only five FHA-HAMP partial claims that had also been reviewed by the contractor. According to Mortgagee Letter 2009-23 in place at the time these claims were submitted, to be eligible under FHA-HAMP program the front end debt to income ratio must be as close as possible, but not less than, 31 percent. Of the five reviews, three claims (60 percent) totaling $21,685 were ineligible due to servicer income calculation issues and because the new payment was below 31 percent of gross income;[3] however, the contractor noted no findings during its reviews.

[3] The three ineligible case numbers include (1) $11,975 for FHA case number 093-5946317, (2) $7,455 for FHA case number 441-9071531, and (3) $2,255 for FHA case number 331-1338920.

HUD pays claims automatically, based on data submitted by the servicer and the servicer's certification that the claims are true and correct. HUD hired the contractor to perform the postclaim reviews as an internal control to ensure that the submitted claims were eligible. Based on the quality of the reports submitted to HUD and the five claims reviewed, we determined that HUD's postclaim reviews were not effective.

HUD Did Not Approve Reviews in a Timely Manner

According to the performance work statement, HUD's contractor was hired to perform approximately 70 quality control reviews each year, which included all claim types. However, the contractor completed significantly fewer reviews as shown in the figure below.



In addition, the contractor had 32 reviews started under its contract that were still open as of April 23, 2015.

According to the contractor, typical reviews can take 60 to 100 days but may take longer depending on the response time by the servicers. However, the most significant factor slowing down the reviews was that HUD was behind on assigning new reviews and approving postclaim review reports submitted by the contractor. The contract stated that HUD had 5 business days to return unacceptable reports. The contractor stated that HUD sometimes took several months to return reports and that some reports went back and forth a number of times.

HUD's Contractor Oversight Was Inadequate

HUD had only one employee and a small business contractor overseeing a program that paid $16.7 billion for all home retention and home disposition claim types in fiscal year 2011. HUD stated that it stopped assigning and reviewing postclaim reviews for 3 weeks to complete another task and it would take a while to catch up. Due to HUD's lack of resources devoted to this oversight function, HUD had fallen behind on assigning, reviewing, and approving the contractor's reviews. As a result, the contractor's completion of the reviews lagged, and the effectiveness of the quality control function was diminished.

Performing the postclaim reviews is critical to ensuring servicers' program compliance. We reviewed a statistical sample of 135 FHA-HAMP partial claims from the top 9 servicers and determined that 27 were either ineligible or eligible for less than claimed for a total of $392,988 in ineligible costs. This condition was due to calculation issues concerning income, the target payment, the current payment, principal deferment, and arrears. In addition, HUD did not receive funds for two claims that the servicer determined to be ineligible (see appendix D). Based on the results of the sample, HUD's claim payment system paid approximately $177 million in ineligible partial claims that would not be identified by its postclaim review process. In addition, three claim files lacked adequate income or arrears documentation to support $94,120 in claims (see appendix D). If HUD had the proper controls, approximately $88.5 million per year could be put to better use.

Conclusion

HUD did not have effective controls over its postclaim reviews for the FHA-HAMP partial claim option. We reviewed a statistical sample of 135 FHA-HAMP partial claims and determined that 27 were either ineligible for the program or eligible for less than claimed.[4] Because HUD's postclaim review controls were not effective in identifying ineligible claims processed by its claim payment system, HUD overpaid at least $177 million in partial claim notes due to servicer miscalculations, which affected at least 21,200 loans. If HUD had the proper controls, approximately $88.5 million per year could be put to better use.

[4] Refer to appendix D for a summary of the results from claim file reviews.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Finance and Budget

1A. Assign the necessary administrative resources and oversight to reduce potential losses of $88.5 million per year for ineligible FHA-HAMP claims that may go undetected by HUD's controls.

1B. Require servicers to repay HUD $414,673 for the 30 identified partial claims with excessive amounts (This includes $21,685 from our review of the contractor and $392,988 from our statistical sample summarized in appendix D).

1C. Require servicers to repay HUD $94,120 or provide supporting documentation for the three files that did not include adequate documentation (see appendix D).

1D. Provide training to staff assigned to postclaim reviews and the postclaim review contractor on all loss mitigation programs.

1E. Review a sample of postclaim reviews submitted by the contractor to ensure that the contractor adequately identifies ineligible claims.

Finding 2: HUD Did Not Have Clear Program Guidance in Place for the FHA-HAMP Partial Claim Loss Mitigation Option

HUD did not have clear guidance in place to ensure that servicers understood and followed the FHA-HAMP partial claim loss mitigation option as intended. This condition occurred because HUD lacked attention to detail concerning FHA-HAMP. As a result, servicers applied HUD program guidance in different ways, resulting in some claims that were higher than necessary, including $500,871 in exempt ineligible claims.

Servicers Lowered Modification Payments Below the Target Payment

Mortgagee Letter 2013-32 requires the servicer to calculate a target payment based on a percentage of the borrower's gross income or principal, interest, taxes, and insurance (PITI) payment. Using the target payment, HUD's intent was that the servicer would include all arrearages and foreclosure fees in a modification until it reached the target payment. However, the mortgagee letter states, "As part of FHA-HAMP, a partial claim may include an amount needed to cover arrears in loan payments, legal fees and costs associated with a cancelled foreclosure, and potentially any additional amount for principal deferment." Many servicers interpreted this statement to mean that they could include all arrearages and foreclosure fees in the partial claim, which would lower the payment below the target.

HUD identified this interpretation issue and sent a memorandum to all servicers on February 14, 2014, which explained HUD's intent. HUD also issued a frequently asked questions statement that attempted to clarify this issue with the following statement: "Except for when a stand-alone partial claim is permitted, a partial claim cannot include any amount to reduce a mortgagor's [borrower] mortgage payment below the targeted PITI payment."[5] As a result of this interpretation issue, servicers processed an additional $500,871 in partial claim amounts for 32 of 135 files reviewed. HUD's memorandum stated that it would not hold the servicers responsible for the excessive amounts as long as the trial payment plan was in effect before May 1, 2014.

Servicers Limited the Partial Claim to Different Unpaid Balances

Mortgagee Letter 2013-32 states, "The maximum value of all outstanding partial claims for a given loan cannot exceed 30 percent of the outstanding unpaid principal balance as of the date of the default." We identified one servicer that applied the 30 percent partial claim limit to the unpaid balance before the trial payment, while eight servicers in our sample applied the 30 percent limit to the unpaid balance after the trial payments had been applied. For example, one claim had an unpaid balance of $166,543 as of the date of default, before trial payments, which limited the partial claim to $49,963. If the servicer had used the unpaid balance of $165,148

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[5] Refer to appendix C for Mortgagee Letter 2012-22 and 2013-32, Frequently Asked Questions.

after all trial payments had been applied, the partial claim would have been limited to $49,544. This action resulted in a difference of $419 in the maximum partial claim amount. HUD should consider updating its policy to clarify which unpaid balance the servicer should use.

Servicers Included Principal in Arrears

HUD officials stated that principal in arrears could be included in a partial claim; however, Mortgagee Letter 2013-32 states that only interest, escrow advances, and foreclosure costs can be included.[6] We identified one servicer that considered principal in arrears as additional amounts due when calculating the partial claim and loan modification amounts when the principal amount in arrears was included in the loan balance, essentially including principal in arrears twice. This action resulted in an additional $16,122 in ineligible claim amounts paid by HUD for 7 of 135 partial claims reviewed. HUD should clarify how servicers should properly handle principal in arrears in the calculation of the partial claim.

Servicers Did Not Process Stand-Alone Partial Claims When It Was More Beneficial to Borrowers

HUD's policy did not require the servicer to use a partial claim over a traditional FHA-HAMP loan modification and partial claim combination, even when a stand-alone partial claim was more beneficial to the borrower. Mortgagee Letter 2013-32 states that a stand-alone partial claim "may" be used or "is permissible" if certain criteria are met. Because HUD paid an incentive fee to the servicer for FHA-HAMP loan modifications[7] and the servicer could increase the interest rate and extend the maturity term through a modification, the FHA-HAMP combination may not have benefited borrowers.

We noted an instance in which the borrower could have kept the original loan terms with an interest rate of 4.625 percent but the servicer modified the mortgage payment with an interest rate of 4.75 percent and a partial claim of $9,916 (the modification resulted in only an $8 reduction in the principal and interest payment). The servicer not only received an additional $750 incentive fee from HUD for the modification, but would also receive additional interest over the life of the loan. HUD should strengthen its policy regarding the use of a loan modification when a stand-alone partial claim is permitted to ensure that it is beneficial to the borrower.

Servicers Processed FHA-HAMPs Without Verifying the Cause of Hardship

According to Mortgagee Letter 2013-32, in order to qualify for FHA-HAMP, the mortgagor(s) of record must provide a signed hardship affidavit and the household or mortgagor(s) has experienced a verifiable loss of income or increase in living expenses. However, HUD policy did not clarify what level of documentation was required from the servicer to determine whether

[6] Refer to criteria in Mortgagee Letter 2013-32 in appendix C.
[7] Refer to criteria in Mortgagee Letter 2009-23 in appendix C.

the borrower had a verifiable loss of income or increase in living expenses as explained in the hardship affidavit. In one example, the borrower's hardship affidavit stated that the borrower had reduced income, but the servicer did not document the decrease in income. In addition, the hardship was questionable because the servicer determined that the borrower had surplus income of $539 before the partial claim. HUD should update its policy to include examples of documentation that is required to verify the hardship, such as prior pay stubs or bank statements showing that the borrower had a decrease in income and new loan agreements or medical bills to provide evidence of increased living expenses.

Servicers Did Not Always Adequately Analyze Living Expenses

According to Mortgagee Letter 2013-32, the servicer must analyze surplus income to determine whether the borrower is eligible for other loss mitigation options before proceeding to FHA-HAMP.[8] Therefore, it is important for the servicer to attempt to determine an accurate surplus income. However, HUD did not have clear requirements concerning the documentation needed for analyzing living expenses.

We noted situations in which the expense items claimed appeared to have been overestimated or underestimated for expenses that could not be verified by the credit report. For example, in one case, the servicer listed only expenses for food and nothing for utilities or other non-credit-report expense items. It is unlikely that the borrower did not have other non-credit-report expenses. In another example, the borrower listed additional recurring debt items as expenses on the hardship affidavit, but the servicer did not include the expense items because they were not on the credit report. These examples did not affect eligibility, but the servicer should be required to document why a discrepancy from the hardship affidavit and credit report existed. Due to the potential to affect eligiblity, the lack of clear requirements for documenting borrower expenses left the program open to abuse.

Servicers Did Not Always Use the Most Appropriate Income Calculation

Mortgagee Letter 2009-32 states, "The mortgagor's Monthly Gross Income amount before any payroll deductions includes wages and salaries, overtime pay, commissions, fees, tips, bonuses, housing allowances, other compensation for personal services, Social Security payments, including Social Security received by adults on behalf of minors or by minors intended for their own support, annuities, insurance policies, retirement funds, pensions, disability or death benefits, unemployment benefits, rental income and other income." This was the main guidance included in HUD's policy for income for FHA-HAMP. Due to the lack of written guidance, servicers determined income in different ways.

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[8] Refer to criteria in Mortgagee Letter 2013-32 in Appendix C.

For example, HUD policy did not address whether the servicer should increase nontaxable income by 25 percent to determine gross income or when to reduce income by 25 percent to determine net income for business income or rental income. In one example, if the servicer had not increased gross income by 25 percent for Social Security income, the claim would not have been eligible for the $24,453 partial claim paid by HUD.

In addition, HUD's policy did not address when it would be acceptable to exclude income from a coborrower or include income from a nonborrower spouse. In one situation, the servicer did not include income of the coborrower because the hardship affidavit stated that the coborrower did not contribute income to the mortgage. However, the coborrower was listed on the partial claim and modified note. We could not determine whether this issue affected eligibility because it was unclear how much the coborrower made; however, if the coborrower made at least $1,000 in gross income per month, the $23,250 partial claim would not have been eligible. In another situation, a servicer included income from a nonborrower spouse. The loan would not have been eligible for the $65,096 partial claim without this income.

Several other income issues were noted during our review that were not addressed in the FHA-HAMP policy. When we discussed this issue with HUD, it stated that it referred servicers to its origination handbook for guidance on calculating income. However, the origination handbook did not align with HUD's loss mitigation policy because it did not include items such as the difference between gross and net income for nontaxable income, business income, or rental income as discussed in the examples above. A small change in income can have a large impact on the dollar amount of the partial claim, or it may impact the eligibility of the claim for FHA-HAMP if it increases the surplus income above $300 or more than 15 percent of the borrower's net monthly income.[9] Because of the potential to change the partial claim amount and the eligibility of the claim for FHA-HAMP, HUD needs to strengthen its policy concerning gross and net income.

Servicers Processed FHA-HAMPs for Borrowers With Negative Surplus Income After the Modification or Partial Claim

We identified 62 of 135 (46 percent) loans with a negative surplus income after the FHA-HAMP modification or partial claim. From the 62 with negative surplus income, 15 (24 percent) were reported as delinquent by the servicer within 6 months. HUD stated that the borrower was not required to have positive surplus income after modification; instead, the borrower was required to pay three or four trial payments.[10] The borrowers' household budget used to determine surplus income showed that they could not afford the modified loan payments. In addition, the servicers reported 65 of the 135 (48 percent) claims reviewed as delinquent at least once after the

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[9] Refer to criteria in Mortgagee Letter 2013-32, attachment in appendix C.
[10] Refer to criteria in Mortgagee Letter 2009-23 in appendix C.

FHA-HAMP was processed. The completion of a trial payment period may not be sufficient to determine the borrower's ability to meet the mortgage obligation because borrowers may have temporary surplus cash due to the lack of recent mortgage payments or may have obtained temporary assistance to make the trial payments.

Servicers Determined the Target Payment Using Different Values for the Current Mortgage Payment

Mortgage Letter 2013-32 limits the target payment by using either 80 percent of the current mortgage payment or a percentage of gross income. The current mortgage payment includes principal, interest, and an amount for escrowed items before the FHA-HAMP analysis. Two servicers used the reanalyzed escrow payment determined as part of the FHA-HAMP analysis, which resulted in $14,399 in ineligible claim amounts, in cases in which the reanalyzed escrow payment was lower than the current escrow payment. According to HUD, the servicer should use the current escrow payment before analysis. HUD should add clarification to this issue to ensure that all servicers determine the target payment consistently.

Conclusion

HUD did not have clear program guidance in place for the FHA-HAMP partial option. This condition occurred because HUD lacked attention to detail concerning FHA-HAMP. As a result, servicers applied HUD policies in different ways, resulting in some claims that were higher than necessary, including $500,871 in excessive partial claims, for which HUD could not seek reimbursement because the policy was unclear.

Recommendations

We recommend that the Deputy Assistant Secretary for Single Family Housing

2A. Update Mortgagee Letter 2013-32 to ensure that servicers do not reduce the modified FHA-HAMP payment below the target payment.

2B. Update Mortgagee Letter 2013-32 to ensure that servicers apply the partial claim 30 percent limit to the correct unpaid balance.

2C. Update Mortgage Letter 2013-32 to clarify how servicers should properly handle principal arrears in the calculation of the partial claim.

2D. Strengthen policies in Mortgagee Letter 2013-32 to ensure that servicers do not use an FHA-HAMP modification and partial claim combination when a stand-alone partial claim is allowable and more beneficial to the borrower.

2E. Develop additional policies and procedures for hardship verification.

2F. Develop additional policies and procedures for the calculation and verification of living expenses.

2G. Develop additional policies and procedures for calculating gross and net income under the loss mitigation options.

2H. Update Mortgagee Letter 2013-32 to require that borrowers have surplus income after the FHA-HAMP modification.

2I. Update Mortgagee Letter 2013-32 to ensure that servicers calculate the target payment based on the original mortgage payment before escrow analysis.

Scope and Methodology

We performed our audit fieldwork from February 4 through August, 7 2015. Our audit period covered claims prepared from October 1, 2012, to September 30, 2014.

To accomplish our objective, we

- Reviewed HUD policies and reference materials related to HUD's loss mitigation requirements,
- Interviewed HUD personnel and HUD's postclaim contractor,
- Reviewed postclaim review findings for five FHA-HAMP claims, and
- Reviewed servicer documentation for 140 FHA-HAMP claims.

For our review of the 140 claims, 5 were claims reviewed by HUD's postclaim review contractor; the remaining 135 were from a statistical sample.

HUD's Single Family Data Warehouse database is a large collection of database tables dedicated to support analysis, verification, and publication of FHA single-family housing data. Using data from HUD's Single Family Data Warehouse database, we identified troubled loans for which HUD had provided a lump sum payment in the form of a partial claim to restore the loan to performing status. These data were pulled from HUD's LOSS_MITIGATION table for a 2-year period between October 1, 2012, and September 30, 2014, as defined by the date claim prepared field. Negative transactions and partial claims exceeding $120,000 were discarded as outliers. Claims were limited to those with claim status code of 1 (Claim paid and disbursed without correction required), 2 (Claim suspended then paid and disbursed), A (Claim paid, but not disbursed pending receipt of electronic funds transfer FT data), or B (Claim suspended then paid, but not disbursed pending receipt of electronic funds transfer data) to weed out any unapproved claim transactions. For simplicity, we limited our inquiry to the top nine loan servicers. These servicers handled 87 percent of the partial claims prepared during this period for an audit sampling universe of 196,483 partial claims amounting to more than $4.6 billion.

These claims were used for two separate types of projections: (1) dollars for ineligible or partially ineligible claims and (2) total number of partial claims having this problem. To keep a reliable, tight projection of ineligible dollar amounts, we used an optimized Neyman sample design. In this way, additional sampling accuracy was applied to the high dollar strata. To allow for a reasonably precise projection of the number of loans affected, we also designed the sample with a minimum of five loans per stratum. In this way, each stratum was represented well enough for a projection of loan counts.

Using this sample design, the audit team acquired records from servicers and reviewed their conformity to HUD's program rules with respect to income levels, monthly payment amounts, etc. Ineligible amounts were calculated for each sample. In cases in which the entire claim was ineligible, fees paid to the servicer were included in the stated finding amount. Percentages, counts, and dollar amounts were estimated and projected for ineligible claims. Because all randomly selected samples are subject to "the luck of the draw," we calculated a margin of error for each type of measure and made a final projection on that basis.

Based on our sample of partial claims, we found that HUD overpaid at least $177 million in partial notes due to servicer miscalculations. These problems affected at least 21,200 loans, and the actual number could be substantially higher. Extrapolating our 2-year findings to a single year, we estimate that $88.5 million per year could be put to better use by applying proper controls to the partial claims program.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Controls related to HUD's postclaim reviews for FHA-HAMP partial claims.
- Policies and guidance intended to ensure that servicers understood FHA-HAMP.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- HUD did not have an effective postclaim review function (finding 1).
- HUD did not have clear guidance in place to ensure that servicers understood and followed the FHA-HAMP partial claim loss mitigation option as intended (finding 2).

Appendixes

Appendix A

Schedule of Questioned Costs and Funds To Be Put to Better Use

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A			$88,500,000
1D	$414,673		
1E		$94,120	
Totals	**$414,673**	**$94,120**	**$88,500,000**

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations. In this instance, the ineligible costs include three ineligible claims of $21,685 from our review of the contractor's files and 27 ineligible claims of $392,988 from our statistical sample of 135 partial claims that had excessive amounts paid (see appendix D).

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures. In this instance, unsupported costs include claims without adequate documentation on file to verify eligibility (see appendix D).

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, implementation of recommendation 1A to assign the necessary administrative resources and oversight needed will reduce potential losses of $88.5 million per year for ineligible FHA-HAMP claims that may go undetected by HUD’s controls.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation | **Auditee Comments**

OFFICE OF HOUSING

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

SEP 0 9 2015

MEMORANDUM FOR: Tanya E. Schulze, Regional Inspector General for Audit, Region IX, 9DGA

FROM: George J. Rabil, Jr., Deputy Assistant Secretary for Finance and Budget, HW

Kathleen A. Zadareky, Deputy Assistant Secretary for Single Family Housing, H U

SUBJECT: Discussion Draft Report
HUD Did Not Have Effective Controls or Clear Guidance in Place for the FHA-HAMP Partial Claim Loss Mitigation Option
Review Audit Report Number: 2015-LA-000X

Thank you for providing the Office of Housing the opportunity to comment on the Office of Inspector General's (OIG) draft audit report entitled, *HUD's FHA-Home Affordable Modification program's (FHA-HAMP) Partial Claim Loss Mitigation Option* (2015-LA-000X). Please find our comments below:

Comment 1

Recommendation 1A: Assign the necessary administrative resources and oversight to reduce potential losses of $88.5 million per year for ineligible FHA- HAMP claims that may go undetected by HUD's controls.

The Office of Finance and Budget (FAB) partially agrees with the OIG's recommendation.

Improving the post claims' review process is a part of FAB's goals for FY15 and FY16. We have assigned three staff members to the post claims' review team. In addition, we are in the process of procuring a new post claims' review contractor. The post claims' review team plans to accompany the new contractor on some reviews in the future to help ensure proper oversight of the post claims' review process.

Efforts are underway with Single Family Housing, specifically the Quality Assurance Division (QAD), to coordinate related mortgage servicer reviews. We are committed to working with QAD and other offices within Housing to strengthen controls and oversight of FHA's program participants.

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Comment 2

Comment 3

Comment 4

Comment 3

Comment 3

FAB disagrees with the OIG's statement that the lack of post claims' oversight led to a potential loss of $88.5 million per year due to ineligible FHA-HAMP claims. With regards to the FHA-HAMP Partial Claim review, the scope of the review includes ensuring the following: all pertinent documentation is maintained in the claim file, the information entered on Form HUD-27011 agrees with the promissory note/subordinate note, the partial claim does not exceed thirty percent of the Unpaid Principal Balance as of the date of the initial default, a loan modification or FHA-HAMP is filed only once in a 24-month period, and the partial claim is received within 60 days of the recorded execution date of the promissory note/subordinate note in order for the servicer to claim an administrative/incentive fee. Based on the Post Claim contractor's scope of work, the servicing eligibility criteria used in the OIG's audit (referenced in Appendix D) are not a part of FHA's post claims' review process. Such criteria are audited as part of QAD's servicing review process. Therefore, even if FAB had conducted more post claim reviews, the findings listed in Appendix D would not have been identified.

Recommendation 1B: Require servicers to repay HUD $414,673 for the 30 identified partial claims with excessive amounts (this includes $21,685 from our review of the contractor and $392,988 from our statistical sample, summarized in appendix D).

The Office of Single Family Housing will review the cases listed on appendix D and take the appropriate actions, as necessary.

Recommendation 1C: Require servicers to repay HUD $94,120 or provide supporting documentation for the four files that did not include adequate documentation (see appendix D).

Based on the findings reflected in Appendix D, only three of the OIG's sample cases were listed as having unsupported documentation as opposed to the four cases referenced in the recommendation. Nonetheless, the Office of Single Family Housing will review the cases reflected in Appendix D and take the appropriate actions, as necessary.

Recommendation 1D: Provide training to staff assigned to post claim reviews and the post claim review contractor on all loss mitigation programs.

FAB agrees with the OIG's recommendation and is in the process of acquiring a new post claims' review contractor for future reviews. This new contract has a targeted award date of October 1, 2015. FAB will provide requisite training to both the new contractor and any HUD staff assigned to oversee post claim reviews.

Recommendation 1E: Review a sample of post claim reviews submitted by the contractor to ensure that the contractor adequately identifies ineligible claims.

FAB agrees with the OIG's recommendation that a sample of post claim reviews, submitted by the contractor, must be reviewed by the Post Claim staff. However, FAB will only identify the ineligible claims per its Post Claim contractor's scope of work. Post Claim staff will ensure that the contractor's reviews are conducted properly and in accordance with FHA's Single Family Insurance Claims Handbook, 4330.4 Rev. 1, and relevant mortgagee letters and HUD regulations. Also, Post Claim staff plan to accompany its contractor on some post claims reviews to monitor their review procedures for accuracy.

Comment 3

Comment 3

Comment 3

Comment 5

Comment 3

Recommendation 2A: Update Mortgagee Letter 2013-32 to ensure that servicers do not reduce the modified FHA-HAMP payment below the targeted payment.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which includes examples illustrating that no portion of a Partial Claim can be used to reduce a mortgagor's modified principal, interest, taxes and insurance (PITI) mortgage amount below the targeted payment for an FHA-HAMP loan.

Recommendation 2B: Update Mortgagee Letter 2013-32 to ensure that servicers apply the maximum Partial Claim amount of 30 percent to the mortgagor's correct unpaid balance.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which includes examples illustrating that the maximum, cumulative value of all partial claims paid per loan shall not exceed 30 percent of the correct unpaid principal balance (UPB) of a loan.

Recommendation 2C: Update Mortgagee Letter 2013-32 to clarify how servicers should properly handle principal arrears in the calculation of the Partial Claim.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which includes examples illustrating the portion of principal arrearages that may be included in a partial claim.

Recommendation 2D: Strengthen policies in Mortgagee Letter 2013-32 to ensure that servicers do not use an FHA-HAMP modification and partial claim combination when a stand-alone partial claim is allowable and more beneficial to the borrower.

Currently, Mortgagee Letter 2013-32 stipulates that "an FHA-HAMP Stand-alone Partial Claim is permissible if the mortgagor's (i) current interest rate is at or below the market interest rate; and (ii) the mortgagor's current mortgage payment is at or below the targeted payment". Therefore, the Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 highlighting this existing requirement.

Recommendation 2E: Develop additional policies and procedures for hardship.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which states that hardship for purposes of assisting a delinquent mortgagor through use of FHA's Loss Mitigation options – must be demonstrated by mortgagor-provided evidence of an increase in living expenses or a loss of income. This updated Mortgagee Letter will further communicate: (1) that FHA-approved servicers have the delegated authority to request the documentation they deem necessary from mortgagors to substantiate a hardship; and (2) supporting documentation for hardship may be in the form of bank statements, medical bills, home repair bills, etc.

Comment 3

Comment 6

Comment 7

Recommendation 2F: Develop additional policies and procedures for the calculation and verification of living expenses.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which indicates that the mortgagee must verify the mortgagor's monthly living expenses by ensuring that all expenses on the mortgagor's Credit Report are included in the mortgagee's calculation of living expenses along with any other expenses that can be supported by bills, receipts, and/or the standard payment amount(s) reflected on the IRS Collection Financial Standards as allowable living expenses (i.e., for utilities, clothing, etc.).

Recommendation 2G: Develop additional policies and procedures for calculating gross and net income under loss mitigation options.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 that advises servicers to use FHA's single family loan origination guidelines in calculating income for FHA's Loss Mitigation options.

Recommendation 2H: Update Mortgagee Letter 2013-32 to require that borrowers have surplus income after the FHA-HAMP modification.

FHA eliminated the FHA-HAMP's Back-end Ratio because there was no such requirement for a delinquent mortgagor to receive a HAMP modification on conventional loans, and conventional HAMPs were defaulting at a substantially lower rate than that of the FHA-HAMP loan. The primary correlation between re-default rates under the two types of HAMP products was the percentage of mortgage payment relief the mortgagor received.

As such, in its publication of Mortgagee Letter 2012-22 on November 16, 2012, FHA eliminated the Back-end Ratio on its FHA-HAMP loans. To help further reduce re-default rates and provide sustainable mortgage payments on its modified loans, FHA established a 20 percent targeted mortgage payment reduction for FHA-HAMP loans and required a Front-end Ratio of no more than 40 percent. These actions resulted in FHA's re-default rates decreasing to less than 8 percent, which is a historical low.

In addition, less than 50 percent of FHA's delinquent mortgagors (i.e., approved for FHA loan modifications) actually wind up receiving a permanent FHA-HAMP because they fail their Trial Payment Plan. Thus, we believe successful completion of the Trial Payment Plan is a better indicator of a mortgagor's financial ability and/or willingness to meet his/her obligations under a loan modification than a mortgagor simply having surplus income.

Comment 3

Recommendation 2I: Update Mortgagee Letter 2013-32 to ensure that servicers calculate the targeted payment on the original mortgage payment before escrow analysis.

The Office of Single Family Housing will issue an update of Mortgagee Letter 2013-32 which includes examples illustrating that the PITI mortgage payment at the time of the current default should be used when calculating the targeted 20 percent mortgage payment reduction.

We look forward to working with you and your team throughout the remainder of the audit process.

OIG Evaluation of Auditee Comments

Comment 1 We commend the Office of Finance and Budget for taking such timely actions to address the recommendations and we look forward to working with HUD on resolving this recommendation.

Comment 2 We understand that the contract does not specifically state that the contractor was supposed to review eligibility items noted in the findings; however, the contractor was reviewing claims for eligibility at the time of our audit. The HUD employee responsible for reviewing the contract stated that he was not sure which requirements the contractor reviewed concerning HAMP because he did not have time to review their work thoroughly. In addition, the claim deficiencies identified in the audit report persisted despite any reviews that were conducted by HUD's Quality Assurance Division (QAD). Therefore, we continue to believe that corrective action is needed to ensure that future ineligible HAMP claims are prevented. We agree that the use of QAD to strengthen the claim review process could be a valid approach to addressing the pattern of claim deficiencies within the HAMP program. However, because the sample selection process for QAD reviews may result in only a very small sample of completed HAMP claims, any additional controls should be designed to ensure that patterns of HAMP claim deficiencies can be identified and addressed.

Comment 3 We look forward to working with HUD to close out this recommendation.

Comment 4 We corrected the recommendation to state "three" instead of "four" files. We look forward to working with HUD to close out this recommendation.

Comment 5 The case identified in the audit report met these requirements. However, because the policy states that it is "permissible" and not required, the servicer completed a FHA HAMP partial claim and modification combination. HUD's policy should ensure that a stand-alone partial claim is required when it is more beneficial to the borrower.

Comment 6 We agree that origination guidelines can be used to clarify some income items. However, HUD's origination handbook does not align with HUD's loss mitigation policy because it does not include items such as the difference between gross and net income for non-taxable income, business income, or rental income as discussed in the audit report. HUD should update its loss mitigation policy to include income situations specific to loss mitigation to close out this recommendation.

Comment 7 We agree that the trial payment plan is a good control to evaluate whether the borrower can make the new loan payment. However, we identified 62 of 135 claims with negative surplus income and 24 percent of those claims were reported as delinquent within 6 months after the modification. The borrower's household budget used to determine surplus income showed that the borrower could not afford the modified loan payments. HUD should include a requirement that the final surplus income is positive as an additional control to ensure the borrower can afford the new payment.

Appendix C

Criteria

24 CFR (Code of Federal Regulations) 203.365

Documents and information to be furnished the Secretary; claims review.

c) Claim file to be maintained by mortgagee [servicer]. (1) The Secretary may verify the accuracy of information regarding the insurance claim either before payment of the claim or after payment by periodic reviews of the mortgagee's records. Mortgagees must reimburse the Secretary for any claim and interest overpaid because of incorrect, unsupported, or inappropriate information provided by the mortgagee, or because of failure to provide correct information.

(2) Mortgagees must maintain a claim file containing documentation supporting all information submitted for claim payment for at least three years after a claim has been paid. All claim files for claims paid during a period relating to an unresolved or ongoing claim review must be maintained until final resolution of such review. Information to be maintained in the claim file includes receipts covering all disbursements as required by the fiscal data form, ledger cards covering the mortgage transaction, and any additional information or data relevant to the mortgage transaction or insurance claim.

Mortgagee Letter 2009-23

Basic Program Guidelines

To confirm if the mortgagor is capable of making the new FHA-HAMP payment, the mortgagor must successfully complete a trial payment plan. The trial payment plan shall be for a three month period and the mortgagor must make each scheduled payment on time. The mortgagor’s monthly payment required during the trial payment plan must be the amount of the future modified mortgage payment. The Mortgagee must service the mortgage during the trial period in the same manner as it would service a mortgage in forbearance. If the mortgagor does not successfully complete the trial payment plan by making the three payments on time, the mortgagor is no longer eligible for FHA-HAMP. Prior to proceeding to foreclosure, the Mortgagee must reexamine and re-evaluate the borrower’s financial condition and confirm that none of FHA’s other Loss Mitigation options could assist the mortgagor.

Mortgagee Incentives

Mortgagees that utilize FHA-HAMP are eligible to receive incentive payments. Mortgagees utilizing this initiative will be allowed to first file for a partial claim (to bring the loan current and defer principal where appropriate), followed by a loan modification claim (claim type 32). Under FHA-HAMP, the Mortgagee may receive an incentive fee of up to $1,250. This total includes $500 for the partial claim and $750 for the loan modification. Mortgagees may also claim up to $250 for reimbursement for a title search and/or recording fees.

Mortgagee Letter 2013-32

Capitalization of Arrearages for Modifications and Partial Claims

Arrearages for unpaid accrued interest, servicer advances for escrowed items, and related foreclosure costs (e.g., foreclosure attorney fees) can be included in a Loan Modification or FHA-HAMP Partial Claim. Outstanding arrearages capitalized into modifications are not subject to the statutory limit on Partial Claims. However, arrearages and related foreclosure costs included in Partial Claims are subject to the statutory limit of 30 percent of UPB at the time of initial default.

Surplus Income Percentage

The term "Surplus Income Percentage" is defined as surplus income divided by monthly net income (i.e., net take-home income). The Surplus Income Percentage is used in the mortgagee's financial analysis to determine which loss mitigation options are appropriate based on the mortgagor's income. See Mortgagee Letter 2000-05 for further guidance on the Surplus Income Percentage.

Attachment

FHA Loss Mitigation Home Retention Option Priority Order (Waterfall)

Initial Assistance Screens			
Step	Decision Point	Yes	No
1	Household or mortgagor(s) has experienced a verifiable loss of income or increase in living expenses?	Step 2	Informal or Formal forbearance/repayment plan.
2	One or more mortgagors receives continuous income in the form of employment income (*e.g., wages, salary, or self-employment earnings*), social security, disability, Veterans benefits, child support, survivor benefits, and/or pensions?	Step 3	Special Forbearance
3	Surplus income is at least $300 and greater than 15% of the mortgagor's net income?	Step 4	**FHA-HAMP** (Step 6)
4	85% of surplus income is sufficient to cure arrears within 6 months?	Formal forbearance/ repayment plan for 6 months.	**Modification** (Step 5)

Modification *(Requires Successful Completion of Trial Payment Plan)*			
Step	Decision Point	Yes	No
5	Modification would reduce monthly payment by at least the greater of 10% and $100?	• Modified interest rate must not exceed 25 bps above Freddie Mac average, rounded to the nearest 1/8th, at time trial payment plan is offered to mortgagor; • Term of modified loan must be 30 years.	**FHA-HAMP** (Step 6)

Step 6 **FHA-HAMP**[1] *(Requires Successful Completion of Trial Payment Plan)*

- Use of FHA-HAMP is to both alleviate the burden of immediate repayment of arrears and to adjust monthly payments to a level sustainable by the household with current income. FHA-HAMP permits combining a Partial Claim and a Loan Modification.
- Partial Claim: Total amount available is the lesser of: 1) 30% of the outstanding unpaid principal balance less any previous Partial Claims paid on this mortgage; and 2) the sum of:
    1. Arrearages;
    2. Legal fees and foreclosure costs related to a canceled foreclosure action; and
    3. Principal deferment (per below calculation).
- Modification
    1. Calculate the target monthly payment:
        - A. Calculate 31% of gross income.
        - B. Calculate 80% of current mortgage payment
        - C. Calculate 25% of gross income
        - D. Take the greater of B and C
        - E. Take the lesser of A and D
    2. Calculate monthly payment on current loan balance at the market interest rate (not including arrears) and 360 months term.
    3. If result of Step 2 is lower than result from Step 1E, then the mortgagor is eligible for a standard modification at the market interest rate and if necessary a Partial Claim for arrearages, legal fees, and foreclosure costs ONLY, but may not receive principal deferment; otherwise, go to Step 4.
    4. Calculate allowable principal deferment amount
        - A. Reduce loan balance used in Step 2 until calculated mortgage payment reaches target amount from Step 1 or else the maximum allowable principal deferment is reached per amount available as calculated above under Partial Claim.
        - B. If the final mortgage payment is greater than 40% of current income, and there is verifiable unemployment status, then the mortgagor is eligible for a reduced payment option under the Special Forbearance. If there is no verifiable unemployment status and the mortgagor has already been reviewed for retention options under the waterfall but, does not qualify for any (i.e., mortgagor does not have sufficient surplus income or other assets that could repay the indebtedness), then the mortgagor is eligible non-retention options.

Mortgagee Letter 2012-22 and 2013-32, Frequently Asked Questions

3. Can the Maximum Allowable Partial Claim be exhausted in order to reduce the modified loan payment below the targeted PITI payment?

Except for when a stand-alone Partial Claim is permitted, a Partial Claim cannot include any amount to reduce a mortgagor's mortgage payment below the targeted PITI payment.

Appendix D

Sample Claims Reviewed

				Explanation for ineligible amounts							
	Case number	Ineligible amount	Unsupported amount	Income issues	Incorrect target payment	Incorrect current payment	Excessive arrears	Unallowable principal deferment	Front -end ratio lower than 31%	Principal arrears included twice	HUD had not received repayment for ineligible amount
1	249-5304953	$11,749		X							
2	441-9138619	$51,782		X							
3	249-5342176	$16,351			X						
4	541-7457798	$1,018				X					
5	351-5888171	$5,133				X					
6	521-7199139		$23,750	X			X				
7	137-5426045	$8,441						X			
8	043-8650066		$62,900	X							
9	221-3827752	$9,810	$7,470	X							
10	044-5027486	$14,958		X							
11	105-4841733	$3,084		X							
12	094-5545447	$15,082						X			
13	292-5228733	$2,201						X			
14	048-4758253	$95,899		X							
15	105-4868418	$11,988							X		
16	561-9227838	$1,521								X	
17	105-4392327	$3,561							X		
18	511-0242540	$3,195						X			
19	048-5988904	$3,704									X
20	137-5042380	$14,843						X		X	
21	043-8370357	$3,028								X	
22	105-6036608	$3,255								X	
23	277-0753813	$529								X	
24	461-5103759	$7,613				X				X	
25	061-3038539	$58,218									X
26	351-5413916	$34,213		X				X			

	Case number	Ineligible amount	Unsupported amount	Explanation for ineligible amounts							
				Income issues	Incorrect target payment	Incorrect current payment	Excessive arrears	Unallowable principal deferment	Front -end ratio lower than 31%	Principal arrears included twice	HUD had not received repayment for ineligible amount
27	352-6487784	$8,248				X					
28	491-7483117	$1,952								X	
29	197-5141495	$1612					X				
		$392,988	**$94,120**								